

The impact of presidential impeachment on markets

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Political noise has been on the rise in developed markets in recent years, bringing what are regarded as the more stable economies in line with emerging markets. Though it can hardly be ignored, political noise is often hard to trade. In this note, we examine one of the more disruptive political events in a democracy, presidential impeachment.

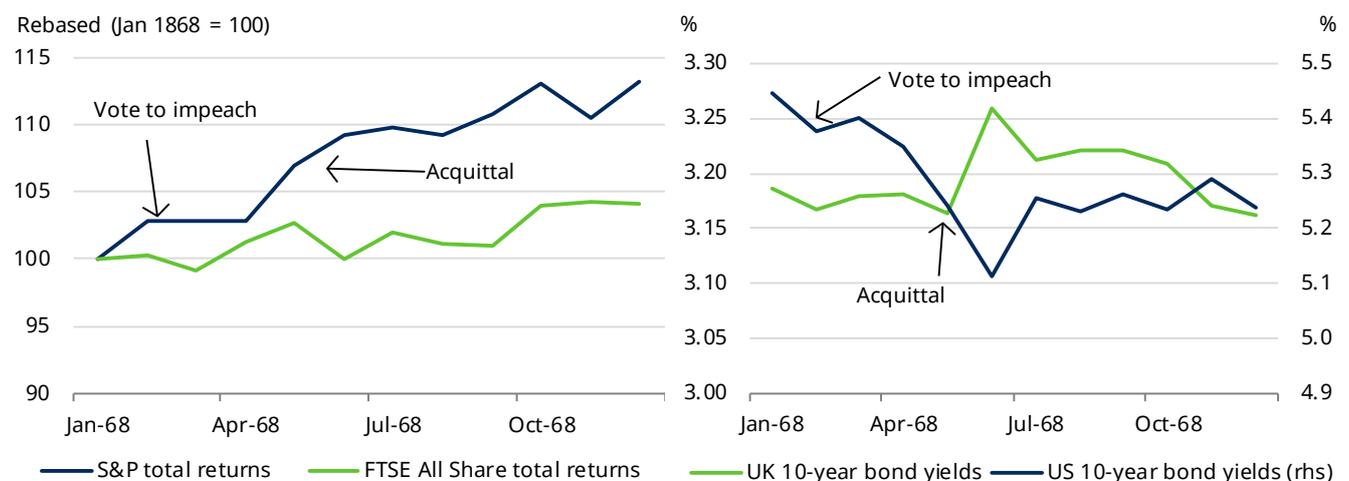
Elements in the US have called for the impeachment of current president Donald Trump for a range of reasons. We can offer no view on the validity of these reasons, but we can look at past US presidential impeachments as a guide to what might happen to the markets. Happily for the US, the incidence of impeachment is limited, with only three impeachment attempts (none successful) since the founding of the republic. Consequently, we also consider a couple of examples from emerging markets, where impeachment was successful.

Andrew Johnson and the Tenure of Office Act

The first impeachment attempt in the US came in 1868. President Johnson, who took office after the assassination of President Lincoln, was charged with violating the Tenure of Office Act by removing the Secretary of War, Edwin Stanton. The vote to impeach came in February 1868, three days after Stanton's dismissal. The trial ended with Johnson's acquittal on 26 May of that year.

The short timescale does not afford us much opportunity for analysis, but all the same chart 1 depicts the performance of US equity and bond markets in 1868, with the UK as a comparator. One could infer that the May acquittal prompted the subsequent outperformance of the US equity market. The bond market meanwhile rallied through the impeachment process before levelling off. Whether this tells us anything about the likely market reaction to impeachment today is highly debatable, of course, given how financial markets have changed since the 1800s.

Chart 1: US asset performance during the 1868 impeachment of President Johnson



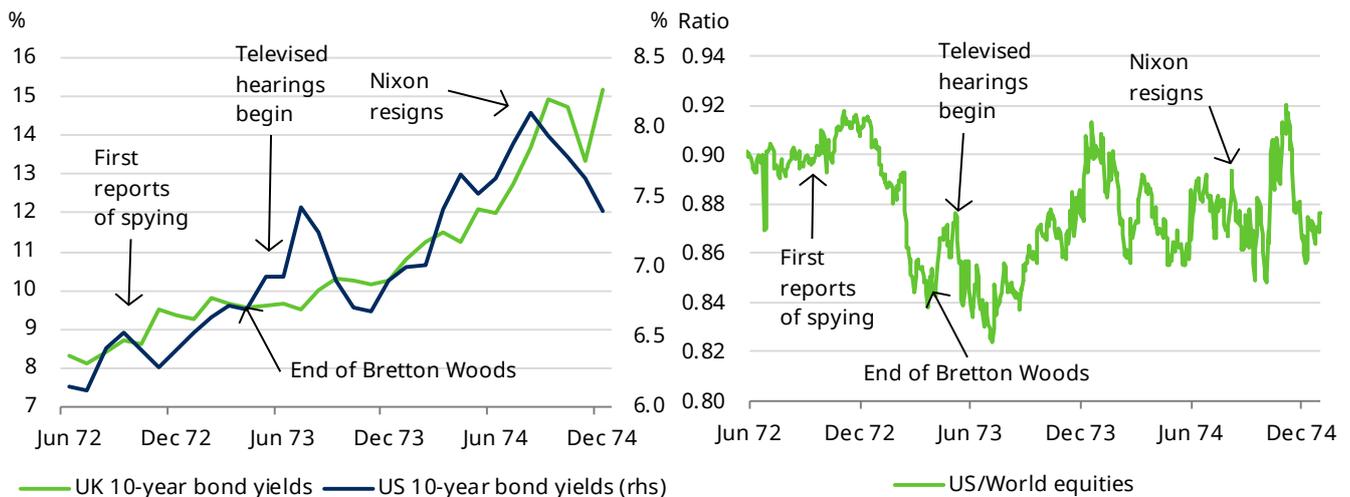
Source: Global Financial Data, Schroders Economics Group. 23 March 2017

Watergate

In June 1972 burglars broke into the offices of the Democratic National Committee at the Watergate office complex. The eponymous scandal followed attempts by the Nixon White House to conceal its involvement; the subsequent investigation by Congress met with resistance from the Nixon administration and prompted a constitutional crisis.

Perhaps the relevant period for markets begins from September 1972, as reports surfaced of Republican-financed spying and sabotage of the Democratic Party. January saw another step up in significance when the burglars were convicted and the ties to the White House were becoming more apparent. Ultimately, Nixon would resign in August 1974, before the impeachment process could conclude. Chart 2 shows how US equities and bonds performed during this time.

Chart 2: The impact of Watergate on US assets



Source: Global Financial Data, Thomson Datastream, Bloomberg, Schroders Economics Group. 15 March 2017.

Teasing out the bond yield response is difficult. For one, the expected reaction is unclear. Nixon's notable economic policies included wage and price controls (which hurt demand), dollar devaluation (which boosts inflation and growth), and a short-lived import tax, which weakened the dollar (another inflation boost). Impeachment could therefore have led to a less inflationary policy set. The rally in bonds, with yields falling through September into November, could reflect hopes of lower inflation.

Equally, the rally might mark a flight to safety as political risk rose. However, bond yields then began to climb steadily. An inflection point was reached in August 1973 after which yields declined until the end of the year. They then climbed again until Nixon's resignation, which seemed to mark a high water point. However, we can see that UK gilts behaved in much the same way, with only some deviations.

US bonds seem to have underperformed between April and July 1973, and outperformed from August 1974. April 1973 saw the resignation of the FBI director for destroying evidence, while the White House counsel was fired, and in May of that year televised hearings began. It seems plausible therefore that Watergate caused some weakness in the US bond market at this time.

However, probably more important is that in March 1973, the Bretton Woods fixed exchange rate system became a floating exchange rate system. As for the outperformance, we think it reasonable to suggest that the resignation of President Nixon provided a catalyst. As mentioned above, investors might have welcomed a change in economic policy, as well as an end to uncertainty.

When considering equity market performance, we take a ratio of the US index against the MSCI World index. We aim here to remove the impact of the OPEC crisis from the data. The S&P 500 underperformed from December 1972 to March 1973, then after a short rally resumed its decline into July, when its underperformance peaked. This of course coincides with the bond market weakness, supporting the idea that Watergate drove asset weakness to some extent. Perhaps oddly, the S&P 500 then outperformed into end

1973, after which relative performance looks fairly trendless, with the index underperforming in the immediate aftermath of Nixon's August 1974 resignation.

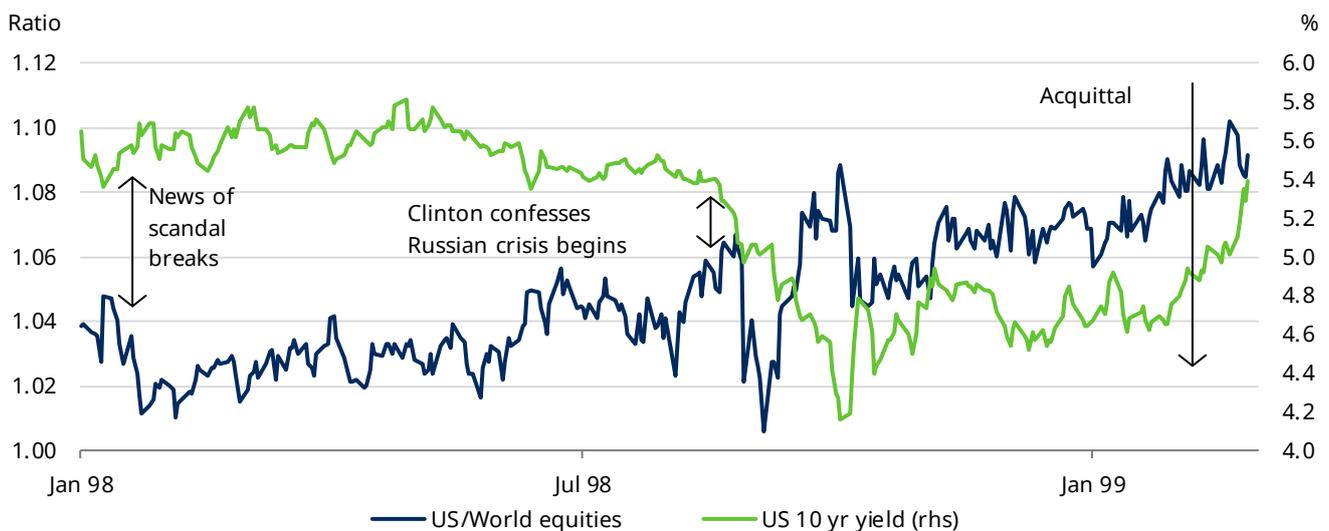
The Lewinsky Scandal

Without going into excessive detail, the news of President Clinton's involvement with Monica Lewinsky broke on 17 January 1998. Lewinsky eventually agreed to testify in late July of that year, and on 17 August Clinton admitted to an "inappropriate" relationship. A Republican dominated Congress voted to begin impeachment proceedings in December for perjury and obstruction of justice. The trial began in January 1999 and concluded with Clinton's acquittal in February of that year.

From chart 3, it is difficult to note much impact of the scandal in the first half of 1998. We do see increased volatility following Clinton's confession, but it should also be noted that this coincided with the Russian debt crisis and subsequent failure of Long Term Capital Management in the US. The US market then outperformed following his acquittal. Bonds, meanwhile, rally on the confession and then sell off on the acquittal. It is tempting to suggest this post-acquittal performance reflects assumptions of fiscal stimulus under a Democratic president. However, this does not tally with the budget surpluses achieved 1998-2001, or the Balanced Budget Act passed in 1997.

An alternative reading is that, with uncertainty over the presidency removed, investment could return and growth expectations rise, prompting rising equities and higher bond yields. Again though, we would be remiss to omit events elsewhere: the tech bubble was inflating rapidly at this point, and is likely muddying the waters.

Chart 3: US asset performance during the Lewinsky Scandal



Source: Thomson Datastream, Schroders Economics Group. 15 March 2017.

With only limited examples available in the US, we could also look at more recent examples elsewhere. Both South Korea and Brazil have successfully impeached their presidents in the last two years, and so could prove instructive examples.

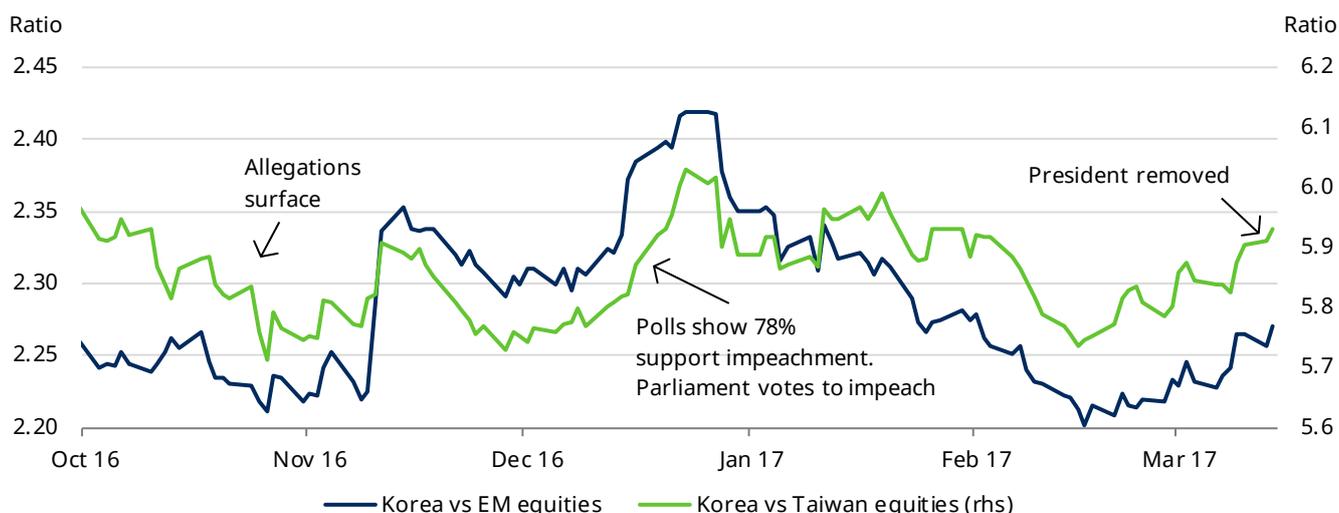
South Korea: Impeachment of Park Geun-hye

In October 2016, it emerged that a key presidential aide in South Korea had abused their position for personal gain. There were allegations too that the same aide had interfered with the policy of the state council. The daughter of a shamanic cult leader, media speculation was rife over the possible religious influence exerted by the aide over President Park. The aide was arrested and, amidst protests, President Park apologised, but to no avail. By December, 78% of South Koreans supported her impeachment, and a parliamentary vote proceeded to that effect. President Park was then suspended for 180 days, and dismissed from her post entirely on 10 March 2017, with new elections held in May of this year.

While shamanic cults made for fascinating media gossip, they seem to have had limited impact on the Korean markets. Chart 4 shows the relative performance of Korean equities and bonds, and equities seemed to perform broadly in line with the rest of the emerging markets (EM) as news of the scandal broke. We do see underperformance versus Taiwan (chosen because it is an equally export sensitive market), but that seems to have been a pre-existing trend.

A more meaningful impact seems to have arisen from the vote to impeach in early December, following which Korean equities outperformed the rest of EM, including Taiwan (so it was not simply the result of stronger global trade, for example). It might also be possible that the November outperformance resulted from anticipation of successful impeachment. However, the positive effect appears not to have lasted long, with underperformance following from January through to mid-February. Korean equities subsequently outperformed peers on news of the arrest of a Samsung vice president for paying bribes to the presidential aide. This might seem an odd factor for a rally, but the arrest brought hopes of corporate governance reforms in Korea, a holy grail for many investors.

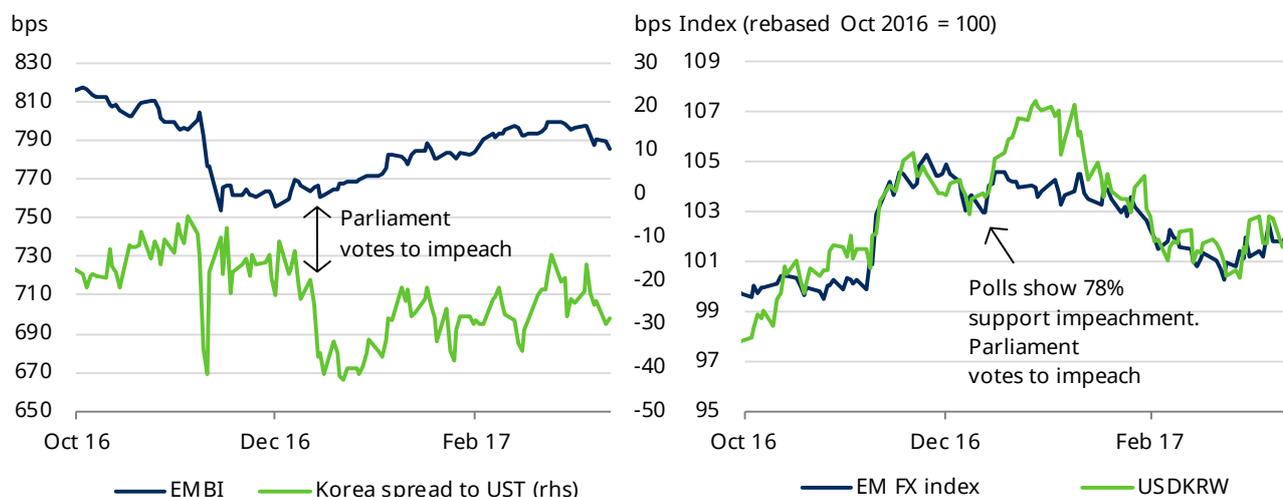
Chart 4: Relative performance of Korean equities



Source: Thomson Datastream, Schroders Economics Group. 15 March 2017.

In the bond space, Korean performance was almost exactly in line with the rest of EM when we look at the spread to US Treasuries, so there seems to have been no discernible impact here. However, if we look at the currency compared to other EM currencies, we can see that the Korean won weakened more than its peers between December 2016 and January 2017, tying in with the weakness in equities. To us, this looks like a flow-driven move in the currency. Otherwise, performance was very much in line with the rest of emerging markets.

Chart 5: Relative Korean fixed income and currency performance



Source: Thomson Datastream, Schroders Economics Group. 15 March 2017.

Brazil: Lava Jato, fiscal pedalling and the downfall of Dilma Rousseff

Perhaps the longest-running case we will discuss, the events leading to the impeachment of Brazilian president Dilma Rousseff began in February 2014, when Operation Lava Jato (Car Wash) commenced. This began as an investigation into money laundering but unearthed corruption at the highest levels of Brazilian business and politics, involving oil giant Petrobras and members of the major political parties.

President Rousseff would win re-election in October 2014, much like Nixon untroubled by the growing scandal. Following a series of revelations and arrests of prominent politicians and businessmen, March 2015 saw protests demanding the impeachment of Rousseff. However, at this stage there was no material evidence suggesting the president herself was corrupt. Protests therefore also focused on her alleged illegal manipulation of the fiscal accounts, also known as fiscal pedalling. In August, the president reached a 71% disapproval rate. The following month, a request for impeachment was filed on the grounds of manipulation of the fiscal accounts. The request was accepted in December, and impeachment occurred in April and May of 2016 as the lower and upper houses held respective votes. Vice President Temer assumed office on 12 May, and became president with Rousseff's removal from office at the end of August.

Chart 6: Brazilian equities and currency boosted by impeachment



Source: Thomson Datastream, Bloomberg, Schroders Economics Group. 16 May 2017.

Brazilian equities and the currency largely benefitted from the impeachment process, showing modest outperformance versus emerging markets as the probability of impeachment grew. As it became apparent that the lower house would vote to impeach, Brazilian outperformance became more pronounced. Rousseff's suspension in May coincided with a temporary ceiling to the equity rally, viewed as all but a done deal after the April vote. Meanwhile the currency continued to gain thanks in part to the high carry it offered for seemingly low risk.

Investors were cheered by the prospect of Rousseff's removal because it promised a move away from left wing populism and the policy paralysis of much of her second term. Vice President Temer, drawn from an ideologically different opposition party, seemed a much more market friendly option with promises to fix the damage done to Brazil's fiscal and economic position.

The impact of uncertainty

Before we conclude, let's take a quick look at how impeachments feed through to market volatility. Intuitively, the increased uncertainty generated by an impeachment attempt should lead to higher volatility because the expected return is less clear. Table 1, below, shows the annualised volatility for the equity markets considered in the above, alongside "control" groups, in the form of global and EM indices.

Impeachments in the US (we have omitted President Johnson due to data constraints) seem to boost volatility relative to the historical average (excluding crisis periods), and also to widen the volatility gap between the S&P 500 and the MSCI World index. However, in Korea's case, the impeachment of President Park seems associated

with lower volatility than the historical average, though it is worth noting that all markets show much lower volatility in this period. We suspect confounding effects from global easy monetary policy and a stabilising China are suppressing volatility in this time period. For Brazil, President Rousseff's impeachment seemed to generate marginally higher volatility relative to historical norms (from which we have stripped out a lot of Latin American crises!). However, volatility was also higher in the US, and broader EM and MSCI World indices in this period.

Overall then there is weak, rather than compelling, evidence that impeachment leads to higher volatility. However, if globally easy monetary policy is the reason for volatility suppression, an impeachment which threatened a change to that status quo seems more likely to generate the volatility increases evident in the US examples.

Table 1: Some evidence impeachments boost market volatility

Annualised volatility (%)	Brazil	Korea	MSCI EM	S&P500	MSCI World
Historical ('96 – present, ex crises*)	23.71	17.55	14.60	13.65	12.02
Nixon (Sep '72 – Aug '74)	#N/A	#N/A	#N/A	15.49	10.72
Clinton (Jan '98 – Feb '99)	64.03	49.51	24.95	19.97	16.05
Park (Oct '16 – Mar '17)	21.29	9.42	11.73	7.52	6.45
Rousseff (Mar '15 – May '16)	25.48	12.69	17.43	15.39	13.49

*ex Global Financial Crisis, LatAm debt crisis, Tequila crisis, Asia debt crisis, Russia crisis, Argentine crisis. Source: Bloomberg, Thomson Datastream, Schroders Economics Group. 16 May 2017.

Conclusion

At first glance there appears to be no obvious pattern. Presidential impeachments are associated with weaker, stronger, and indifferent asset market performance. However, less superficially, we can link the impact on market performance to expectations of policy change resulting from an impeachment. Where the perception is that a government's policies are damaging the economy, the possibility of a change in government boosts asset performance, as in Brazil. However, where a government is seen as benefitting the economy, or at least doing no harm, the prospect of an end to that policy set can induce market jitters. We might read the market reaction to events around President Clinton as an example of this, particular given the rally following his acquittal. Of course, this can be as much due to the removal of uncertainty as a seal of approval on government policy.

Investors concerned about how to trade similar political events – the ongoing struggle to remove President Zuma in South Africa, for example – could therefore consider two key questions. First, what is the likely direction of policy if an impeachment attempt (or similar) is successful? Second, how likely is the success of such an attempt? Though this might seem obvious, sticking to these simple guidelines can provide clarity when one might otherwise drown in market noise.

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